No. 11,160

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

BABETTE G. LURIE,	
	Petitioner,
vs.	
COMMISSIONER OF INTERNAL REVENUE,	
	Respondent.

PETITIONER'S REPLY BRIEF.

OSCAR SAMUELS,
TEVIS JACOBS,
333 Montgomery Street, San Francisco 4, California,
Attorneys for Petitioner.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Table of Contents

Table of Authorities Cited

Cases

Statutes

No. 11,160

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

Babette G. Lurie,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S REPLY BRIEF.

SUMMARY OF ARGUMENT.

(1) Respondent contends that the notes must be in registered form when originally issued. It will be shown that the definition of the word "issued" and the grammatical construction of section 117(f) strongly support taxpayer's position that respondent's contention is unsound. It will also be shown that in any event under section 117(h)(1) respondent's contention does not affect the determination of the case.

(2) In taxpayer's opening brief the issues were clearly defined. It will be demonstrated that the respondent's arguments do not meet the issues and that the authorities cited do not support his position.

ARGUMENT.

I.

AT THE TIME OF THE RETIREMENT OF THE NOTES IN QUESTION THEY WERE ISSUED BY A CORPORATION AND WERE IN REGISTERED FORM AND THUS FALL WITHIN THE TERMS OF SECTOIN 117(f) OF THE INTERNAL REVENUE CODE, REGARDLESS OF THE FACT THAT THEY WERE NOT IN REGISTERED FORM WHEN ORIGINALLY ISSUED.

(a) By definition of the word "issued", notes need not be in registered form when originally issued.

In the case of *Yale Petroleum Company v. Commissioner,* 2 T. C. 1039, the question arose as to whether a mortgage of incorporators of a corporation which was adopted by a corporation was a mortgage "issued by the corporation and in existence at the close of business on December 31, 1937, under Section 27(a)(4), Revenue Act of 1939". Under said section, payments on said types of obligations constituted a credit for undistributed profits tax purposes. The Court said:

> "Was the mortgage upon which the petitioner made the payment in 1938 of $95,000. one 'issued' by petitioner within the meaning of that word as used in section 27(a)(4), Revenue Act of 1938? We think it was. Once petitioner adopted the contract and mortgage of February 12, 1937, as its own, as it clearly did on April 15, 1937, petitioner was as firmly bound thereby as though it had signed the original contract and mortgage. The signing of a new contract and the issuing of a new mortgage by petitioner would have been a useless gesture under the authorities we have cited. Therefore, we think it is correct to hold that by virtue of petitioner's adoption on April 15, 1937, of the contract and mortgage of its promoters, the

> mortgage became one 'issued' by petitioner on April 15, 1937, within the intendment of the statute. The statute says that in order to get the dividends paid credit the mortgage must have been one 'issued' by the corporation and in existence at the close of business on December 31, 1937. Under our interpretation as above set out, the mortgage involved in the instant case meets the above test."

The words "issued by a corporation" cannot be so restricted as to refer to the original issue of an obligation but refer to a situation where obligations of a corporation are existing at the time referred to in the law—in the cited case December 31, 1937, in the instant case at the time of retirement.

(b) The grammatical construction of section 117(f) negatives an interpretation that the notes must be in registered form at the time of issuance in order to fall within its terms.

Eliminating from section 117(f) of the Internal Revenue Code the portions thereof not material to the instant case, the section reads as follows:

> "For the purposes of this chapter, amounts received by the holder upon retirement of notes issued by any corporation, with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

To give to the section the meaning which the respondent seeks to attach to it, it must necessarily read as follows:

> "For the purposes of this chapter, amounts received by the holder upon the retirement of notes issued with interest coupons or in registered form

by any corporation shall be considered as amounts received in exchange therefor."

The very fact that the phrase "with interest coupons or in registered form" is set apart in commas prevents the construction sought by the respondent. The fact that the phrase does not follow the word "issued" likewise defeats the respondent's contention. There is nothing in the language of the section which indicates that it was the intention of Congress that this phrase should modify the word "issued". Rather it is merely a description of notes, the retirement of which shall be considered an exchange.

It is of especial significance that when respondent quotes what he claims is the "decisive portion" of section 117(f) (Res. Br. p. 10) he most carefully eliminates the punctuation which so clearly demonstrates that taxpayer's construction is correct.

There is no justification for the respondent's attempted disregard of the clear language of the statute. In fact, carrying his attempted construction to a conclusion would result in an absurdity. For example, if a corporation issued notes in unregistered form, which notes were returned and registered within a short period thereafter and, years later, were acquired by a taxpayer and subsequently retired, under the respondent's contention said retirement would not constitute an exchange even though the taxpayer or any other then holder of any of said notes were unalive to the fact that they were at any time not in registered form. Every purchaser of every bond would have to

ascertain the original form of issue in order to determine whether the retirement constituted an exchange even though the bonds may have been issued decades before acquisition. There is certainly nothing in the statute warranting a construction that the form at the time of acquisition is material.

(c) The construction placed upon section 117(f) by the taxpayer is in accordance with its purpose.

As explained in taxpayer's opening brief (pp. 11, 12) the obvious purpose of the section compels the conclusion that the taxpayer's construction of section 117(f) is correct.

(d) A reissuance of notes in registered form satisfies section 117(f).

Respondent concedes tht the instant notes were *reissued* in registered form, and that *their determining character may date from the reissuance.* (Res. Br. p. 15.) Assuming that these notes were reissued when they were converted to registered form and therefore fall within section 117(f), then the period for which taxpayer held the notes relates back to the time of the original purchase under section 117(h)(1). (See II(d), p. 13, infra.)

II.

THE RESPONDENT HAS FAILED TO ANSWER THE CONTENTIONS OF TAXPAYER.

Taxpayer endeavored in her opening brief to clarify the issues by pointing out (a) that the notes in question were admittedly capital assets; (b) that said notes were admittedly held by taxpayer for more than two years; and (c) that therefore the sole question was whether or not the retirement thereof constituted a sale or exchange under section 117(f).

Taxpayer will demonstrate that the issues originally outlined by her remain unanswered.

(a) The upholding of taxpayer's contention does not permit of tax avoidance.

Respondent contends and quotes from the Tax Court's opinion that last-minute registration would allow taxpayers to choose their time for registration and thus determine for themselves whether or not they desired to treat the transaction as an ordinary gain or loss or as a capital gain or loss and that such a construction would not be imputed to Congress. (Res. Br. p. 13.) Section 117(f) refers only to notes in registered form and whether or not the notes are registered by the holders is of no consequence. This fact was called to the Court's attention in taxpayer's opening brief at page 14 but has been ignored by the respondent who falls into the same error as did the Tax Court.

Assuming that respondent meant that a taxpayer could determine his position by causing the notes to be converted to registered form (the form being the

only issue under section 117(f)) still the argument is without merit. The control exists in any event. If a person owns an unregistered note and desires to take an ordinary loss he can allow the note to be paid or retired. If he desires to turn the transaction into a capital one he can sell the note even though a day before retirement. Section 117(f) neither adds to nor subtracts from this alternative. This argument was presented by taxpayer in her opening brief (p. 14) and again respondent has failed to meet the issue. (It should be again pointed out that there is no evidence or contention that the conversion of the notes in the instant case into registered form by the issuer, Hilton Hotel Company of California, was for the purpose of tax avoidance.)

Contrary to respondent's contention, no congressional intent favoring respondent can be gathered from the supposed option which a taxpayer may have when that same option exists regardless of the construction placed upon the statute.

(b) Reading all subdivisions of section 117(f) together compels the conclusion that the period during which the notes were in registered form has no application to section 117(f).

At the risk of being repetitive the taxpayer in her opening brief (pp. 8 et seq.) endeavored to present the issue in simplied form and to analyze completely all provisions of section 117 applicable to the instant case. Taxpayer is now accused by respondent of endeavoring to deny that subsection (f) must be read or considered with the other provisions of section 117. (Res. Br. pp. 10, 12.) Respondent argues in line with the opinion of

the Tax Court that "to come within section 117(f) the notes must be in the very least, in registered form for the minimum period provided by section 117(b)". (T. p. 21, quoted in Opening Brief, p. 10.) For some reason respondent and the Tax Court are prepared to read only one portion of section 117(b). This section reads as follows:

> "(b) Percentage Taken Into Account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:
>
> 100 per centum if the capital asset has been held for more than 18 months;
>
> 66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;
>
> 50 per centum if the capital asset has been held for more than 24 months."

It merely holds that certain percentages of profit are taken into account dependent upon the holding period. It does not state that if the asset is held for more than 18 months a long term capital gain or loss results while if it is held for less than 18 months the profit is ordinary income. In either instance the profit or loss is a capital gain or loss. True, under section 117(a)(2) and 117(a)(4) (quoted in Taxpayer's Opening Brief, p. 8) if an asset is held for less than 18 months the profit is a short term capital gain and if held for more than 18 months the profit is a long term capital gain.

It is inconceivable how an argument can be made that section 117 in its entirety provides that retirement of a note which was in registered form for more than 18 months results in a long term capital gain while retirement of such a note which is held for less than 18 months constitutes ordinary income and not a short term capital gain. Nevertheless this argument has been expressly made by the Tax Court and respondent. As the Tax Court stated: "Since petitioner's notes were in registered form for less than * * * [18 months] before retirement they do not qualify under section 117(f)" (T. p. 21, quoted in Taxpayer's Opening Brief, p. 10) and as stated by respondent "Congress * * * clearly intended to extend the provisions of section 117(f) only to persons who had held notes in registered form for the period required by subsection (b)"; but subsection (b) does not provide for any period. By referring to capital assets held for not more than 18 months and to capital assets held for more than 18 months it necessarily applies to all capital assets.

Again we have an argument which was presented in taxpayer's opening brief (p. 10) and again respondent has failed to respond thereto.

In taxpayer's opening brief, at page 10, the question was posed, an example of which follows: Suppose a taxpayer purchased ordinary coupon bonds issued for $110 per $100 face value and three months later said bonds were called and retired, would the respondent claim that the result was an ordinary loss and not a capital loss because section 117(f) does not apply to capital assets which are not held in the prescribed form

for more than 18 months? Certainly the law would require clearly that the loss would be a short term capital loss. Despite the fact that this question was presented in taxpayer's opening brief we find it ignored by respondent who blithely states that section 117(f) does not apply unless the asset is in the form prescribed for at least 18 months. We certainly cannot have one interpretation when a profit arises and another when a loss is incurred.

Since it is definite that section 117(f) applies to all capital assets which are in registered form or with coupons attached and since said section provides that the retirement of such an asset constitutes a sale or exchange the only question remaining is whether or not in the instant case there was a long term capital gain or a short term capital gain. To determine that question we look to section 117(a)(4) which provides in part: "The term 'long term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months." It is conceded that the notes in question were capital assets held for more than 18 months. Therefore the taxpayer is entitled to a long term capital gain.

(c) The authorities do not support respondent's contention.

While admittedly there is no case exactly in point, in taxpayer's opening brief (p. 12) it was pointed out that the question of determining the effect of a sale or exchange of an asset is controlled by the conditions in existence at the date of the sale or exchange. Counsel for respondent takes issue (Res. Br. p. 14) because

we are not dealing here with a sale or exchange but with a retirement. The very section in question (section 117(f)) provides that the retirement shall be considered as an exchange and therefore the respondent's point is without moment. If counsel prefers we shall state that the question of determining the effect of a sale or exchange or retirement of an asset is controlled by the conditions in existence at the date of the sale or exchange or retirement.

In I.T. 3041, 1927-1, C.B. 148 (followed in *Kimbell v. Commissioner,* 41 B.T.A. 940), referred to in taxpayer's opening brief, page 12, it is recognized that the holding period for residential properties subsequently converted into business property commenced not at the time of the conversion but at the time of the original acquisition. Under the law if a house used as a residence is sold at a loss the loss is not allowed. If converted to a business purpose and then sold the loss became, under the law as it then stood, a capital loss if held for two years. The question arose as to the holding period, and it was determined that the period relates to the time of the original acquisition of the property. Counsel distinguishes this case by stating that "of course a house is a capital asset regardless of what kind of property it is". Counsel apparently intimates that the notes in question were not capital assets during the entire period of time they were held by the taxpayer. Of course the notes are unquestionably capital assets for under our present law, as pointed out in taxpayer's opening brief at page 7, all classes of property not specifically excluded are capital assets and notes are not excluded.

Respondent then cites five cases which admittedly refer to different situations, but contends that they indicate that various periods cannot be added together to meet the statutory requirements of section 117. A very brief analysis of those cases will disclose that not only do they refer to different situations but also they do not in any manner support respondent's contention.

In the case of *In re Rogers Estate,* 143 F. (2d) 695 (C.C.A. 2d), certiorari denied 323 U. S. 780, stock was sold and paid for by promissory notes payable in installments. Section 117 applied at the time of the sale of the stock and the fact that the notes were payable over a long period of time after the sale could not affect the consummated sale.

The case of *Helvering v. San Joaquin Co.,* 297 U. S. 496, did not deal with the holding period but merely held that the cost basis of real property is determined at the time of purchase and not at the time of the execution of a prior lease, which contained an option to purchase.

In *Howell v. Commissioner,* 140 F. (2d) 765 (C.C.A. 5th), the Court held that the holding period commenced when a lease (which was held in escrow upon certain conditions) was delivered and became effective.

In *Sommers v. Commissioner,* 63 F. (2d) 551 (C.C. A. 10th), stock was subscribed for but the Court held that the corporation was not bound by the agreement and therefore the holding period commenced when the taxpayer first acquired the stock.

It is clear that none of the foregoing cases has any relation to a situation where one capital asset was held during the entire holding period.

The last case cited by respondent is *Commissioner v. C. A. Sporl & Co.,* 118 F. (2d) 283 (C.C.A. 5th), in which case it is held that the holding period of certain bonds commenced when a creditor surrendered his right as such and an unconditional agreement was reached to accept bonds even though the bonds were not issued for four months thereafter. While this latter case is not especially material it lends some support to taxpayer's (not respondent's) contention.

(d) Under section 117(h)(1) taxpayer is entitled to a long term capital gain.

Internal Revenue Code section 117(h)(1) provides as follows:

> "(h) Determination of Period for Which Held.—For the purpose of this section—
>
> 1. In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged."

In taxpayer's opening brief at page 13 it was pointed out that when a capital asset has been exchanged in a non-taxable exchange the holding period commences under subsection 117(h)(1) at the time of the acquisition of the original asset.

The case of *Gracey v. Commissioner,* 5 T. C. 296, was cited in which the Tax Court held that even though the asset were not a capital asset but was converted into a capital asset by a non-taxable exchange and then sold a few months later, the sale of the asset resulted in a long term capital gain. Once again respondent failed to meet the issue but merely states (Res. Br. p. 17) that the *Gracey* case is on appeal and has no application to the instant case since it refers only to property acquired in connection with a non-taxable exchange. The *Gracey* case is on appeal, presumably because there was no capital asset in existence for more than three months. In the instant case there was a capital asset held by the taxpayer for more than two years and therefore if the conversion of the notes into registered form constituted a non-taxable exchange the *Gracey* case is applicable and in any event the situation would fall directly under section 117(h)(1).

As previously pointed out, respondent contends that the conversion to registered form constituted a reissuance of the notes. (Res. Br. p. 15.) Necessarily the calling of all of the notes by the corporation and the "reissuance" in registered form of all of said notes would be a mere recapitalization and a non-taxable exchange, and no contention is made by the respondent that such exchange was taxable in the year the notes were converted into registered form. If the conversion into registered form amounted to a reissuance as respondent contends then there can be no question but that the taxpayer is entitled to a long term capital gain inasmuch as the case would fall directly under section 117(h)(1).

On the other hand, if there were no exchange and the original asset was held during the entire two year period then the taxpayer's case is even stronger. Certainly if the notes were exchanged and taxpayer was entitled to a long term capital gain it cannot be seriously contended that when the notes were not even exchanged the taxpayer must return the entire profit. No doubt the reason that respondent failed to meet this issue was because no conceivable explanation could be given for holding that a more harsh situation results to a taxpayer when the original asset is held for two years than where the asset is exchanged during the period for a new one.

CONCLUSION.

It is submitted that the notes in question come directly within Internal Revenue Code section 117(f) and that the Tax Court erred in endeavoring to read into the section that which does not exist, namely, that a note must be in registered form for a specified period of time in order for that section to be effective.

Dated, San Francisco, California,
February 8, 1946.

Respectfully submitted,
OSCAR SAMUELS,
TEVIS JACOBS,
Attorneys for Petitioner.